JOINT SUBMISSION BY

Chartered Accountants Australia and New Zealand, The Tax Institute, the Institute of Public Accountants, CPA Australia, Tax and Super Australia and the Law Council of Australia

Draft income tax ruling TR 2017/D2: Foreign Incorporated Companies: Central Management and Control test of residency

Date: 26 May 2017

The Professional Bodies welcome the opportunity to comment on Draft Taxation Ruling TR 2017/D2 (**Draft Ruling**).

GENERAL COMMENTS

The Draft Ruling sets out the Commissioner's preliminary views on how to apply the "central management and control" test of corporate residency (the second statutory test) under section 6(1)(b) of the *Income Tax Assessment Act 1936* (**section 6(1)(b)**).

Relevant background to the definition of corporate residency is set out in the Appendix.

Former Taxation Ruling TR 2004/15 contained the Australian Taxation Office's (**ATO**) long-held views on the statutory corporate residency test contained in section 6(1)(b). The Professional Bodies' understanding is the handing down of the decision in *Bywater Investments Ltd v Commissioner of Taxation and Hua Wang Bank Berhad v Commissioner of Taxation* [2016] HCA 45 (***Bywater***) has prompted the ATO to revisit its views on section 6(1)(b).

In the Professional Bodies' view, the section 6(1)(b) test that applies to corporate residency is a two-limb test. The Draft Ruling only covers one aspect of the test in detail, the 'central management and control' (**CMC**) aspect, and only briefly covers the 'carrying on a business' (**CoB**) aspect. To properly consider the test in its entirety, the second limb regarding CoB should also be addressed.

The CoB test is relevant to both the second and third statutory tests for corporate residency.

The interpretation proposed in the Draft Ruling in relation to the CMC test requires significant adjustment and rethinking.

The Commissioner's preliminary view in paragraph 5 of the Draft Ruling is not consistent with the interpretation of paragraph 57 of the *Bywater* High Court decision. Paragraph 57 refers to the High Court decision *Malayan Shipping Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156 (***Malayan Shipping***)). Importantly, *Malayan Shipping* did not address the interpretation of CMC. The contention in *Malayan Shipping* was solely in respect of the CoB test. Accordingly, paragraph 57 in the *Bywater* decision does not require the Commissioner to revisit the principles of CMC, i.e. there is no inference to be drawn from the CoB test with respect to the CMC test or vice versa.

The Draft Ruling interpretation proposed is extremely problematical in relation to foreign operating subsidiaries of Australian groups, with real business operations and real activities and real directors overseas.

While our preference would have been to revisit (and update if necessary) TR 2004/15, we accept that TR 2004/15 has been withdrawn by the ATO and therefore set out our comments to ensure the Draft Ruling gives relevant guidance to taxpayers on this matter. Pertinent examples should also be included in the Draft Ruling. If not, a practical compliance guideline containing relevant examples should be released concurrently with the final ruling. Such guidance could also contain examples of powers or protocols that the Commissioner would view as favourable or unfavourable when considering the central management and control issues referred to in the Draft Ruling.

We do not at this stage comment on date of effect issues which would arise from the Draft Ruling change of view because we think that a more considered analysis of the issues, informed by consideration of real world examples, will see refinement of the views. We will provide further input on date of effect issues later, if it becomes necessary.

We reiterate that the discussion Draft Ruling requires rethinking.

Please refer to our specific comments below.

SPECIFIC COMMENTS

The Professional Bodies make the following submissions:

Submission 1: The Draft Ruling should make clear that the test in section 6(1)(b) is a two-limb test and not a one-limb second statutory test.

Submission 2: The discussion of the CMC limb in the Draft Ruling needs to be amended.

Submission 3: The Draft Ruling should include detailed discussion of the CoB limb as this forms part of the second statutory test.

Submission 4: The Professional Bodies have great concerns regarding the application of the preliminary views in the Draft Ruling on Australian outbound groups. In particular, the preliminary views would do damage to Australian outbound groups and, we submit, to the Australian tax system. The Professional Bodies submit that the further development of the ruling should include express examples as did TR2004/15, to identify specific issues of significance for outbound groups.

Submission 5: Any guidance provided in the Draft Ruling on the CoB limb will also apply to the third statutory test for corporate residency.

Each of our submission points are discussed in turn below.

1. The test in section 6(1)(b) (the 'second statutory test) is a two-limb test not a one-limb test (Submission 1)

As set out in the Appendix, s(6)(1)(b), the second statutory test of corporate residency, contains two limbs: the company must carry on business in Australia and the company must have its central management and control in Australia.

Firstly, paragraph 2 of the Draft Ruling does not correctly state the statutory test – the word 'and' should be included after the phrase as paragraph (a) 'carries on business in Australia' to correctly reflect the law. The use of the word 'and' indicates that this is a two -limb test.

Secondly, paragraph 5 of the Draft Ruling sets out the ATO's interpretation of the second statutory test and implies that the test only has one limb, being:

> "*If a company has its central management and control in Australia, and it carries on business, it will carry on business in Australia within the meaning of the central management and control*

test of residency…This is because the central management and control of a business is factually part of carrying on a business. It follows that a company carrying on business does so both where it's trading and investment activities take place, and where the central management and control of those activities occurs".

In the Professional Bodies' view, the two limbs appear to be being conflated in paragraph 5. Each limb is a question of fact which must be made out. The view being taken in the Draft Ruling is a wider view of what it means to carry on a business (per *Malayan Shipping*) and is doing away with the operating company versus passive / investment company dichotomy considered in TR 2004/15.

In the Professional Bodies' view, no inference is to be drawn from the CMC test with respect to the CoB test and vice versa.

1.A) ATO's view in TR 2004/15, with useful examples

The ATO's view in TR 2004/15 was in broad terms as follows:

a) The second statutory test was a two limb test, i.e. CoB in Australia and CMC in Australia. Each limb was a question of fact and had to be made out

b) The "nature of the business" of a foreign incorporated company was key in determining corporate residency under the second statutory test. The Commissioner drew a distinction between two types of companies:

   i) Where a company's business activities consisted of operational activities, such as trading, provision of services, manufacturing or mining activities, the location of the company's business would be where the main operational activities took place, not necessarily where the CMC was located; and

   ii) Where a company's business activities consisted of passive dealings, such as investment management, the location of the company's business would be where major decisions were made, i.e. often where the CMC was located

c) The ATO rejected the approach that the mere exercise of CMC would itself constitute the carrying on of a business.[1]

As well as recognising the significance of these issues, TR 2004/15 contained ten examples with multiple iterations.

The ATO's view was elaborated in the analysis in the examples. The ATO view then provided high quality input to taxpayers.

We submit that the same enhancement of the current draft ruling is needed, to develop and discuss examples to illustrate the points we identify above. At minimum TR 2004/15 examples 2 and 7 should be reworked and discussed for the ruling. They illustrate that the ATO was alert to the systemic impact of these issues in 2004, and confirm the need for a similar consideration in 2017 and its globalised business environment.

We would be pleased to participate in a workshop to develop and settle the examples and also discuss specific examples of powers or protocols that the Commissioner would view as favourable or unfavourable when considering the central management and control issues referred to in the draft ruling.

For convenience we reproduce those examples 2 and 7:

[1] Para 37 of 2004/15 stated that "The reference to *Mitchell v Egyptian Hotels Ltd* (1915) AC 1022 indicates that mere trading is not sufficient and that there also has to be CMC in order for a company to be resident in Australia under the second statutory test. However, it does not necessarily support the further proposition that if you have CMC you are also invariably carrying on a business in that jurisdiction"

Example 2 - CM&C in Australia with trading outside Australia

71. Trade Co is incorporated in Papua New Guinea, but its board of directors holds the majority of its meetings in Australia where decisions on the major contracts entered into by Trade Co, its finance, major policies and strategic directions are made. Trade Co undertakes all its trading activities in Papua New Guinea.

72. Trade Co is not a resident of Australia under the second statutory test. Although Trade Co has its CM&C in Australia, it is not carrying on business in Australia.

73. The fact that Trade Co has Board related, administrative support in Australia does not change this outcome, as such activity is considered to be part of the activities of the Board, and not the carrying on of a business of the company.

Example 7 - Parent company - subsidiary does not carry on a business in Australia

86. Parent Co is incorporated and has its CM&C in Australia. Its wholly owned subsidiary, Sub Co, is incorporated in Hong Kong, has all of its board meetings in Hong Kong and carries on a trading business wholly outside Australia. As Sub Co is not carrying on a business in Australia, nor has its CM&C in Australia it is not a resident of Australia under the second statutory test.

87. As Sub Co is not carrying on a business in Australia, it will not be a resident of Australia under the second statutory test even if some or all of its board meetings are undertaken in Australia, or some or all of its high level decision making is undertaken by Parent Co.

1.B) ATO's view in the Draft Ruling

The Draft Ruling sets out the Commissioner's preliminary views on how to apply the CMC test of company residency. The Commissioner concludes that if a company has its CMC in Australia, and it carries on business, whether in Australia or not, it will be taken to carry on business in Australia as a result of its CMC being in Australia. It is not necessary for any part of the actual trading or investment operations to take place in Australia, as the CMC activities are themselves a part of carrying on the business.

The Draft Ruling, overturns the approach the ATO took in TR 2004/15. The ATO relies on paragraph 57 of the High Court decision in *Bywater* to justify this new position stating in footnote 4 of the Draft Ruling that a majority of the High Court in *Bywater* have "put beyond doubt" the view expressed by Williams J. in *Malayan Shipping*.

The High Court in *Bywater* found at paragraph 57:

> "*(vi) Malayan Shipping*
> *On its facts, Malayan Shipping Co Ltd v Federal Commissioner of Taxation comes closer to the present appeals but adds little of relevance. In that case, it was conceded that central management and control of a company incorporated in Singapore was exercised in Melbourne, where a Mr Sleigh resided. That was because, inter alia, the articles appointed Sleigh managing director; empowered him to appoint and remove other directors; provided that a resolution of directors was of no force unless first approved by Sleigh; and required that the seal of the company not be affixed without the authority of Sleigh. The only business done by the company during the relevant period was to charter a ship and to sub-charter it on a number of occasions, that charter being effected in London on instructions cabled from Sleigh in Melbourne, and the sub-charters being organised by Sleigh in Melbourne, where he prepared all the documents before sending them to Singapore for execution. It was contended that, although the central management and control of the company was located in Melbourne, upon a proper construction of the definition of "resident" in s 6 of the 1936 Act, a company should not be regarded as resident in Australia, notwithstanding that its central management and control was exercised from Australia, unless the company were also carrying on its business operations in Australia. Unsurprisingly, Williams J rejected that contention"*
> *(emphasis added).*

The ATO's interpretation in the Draft Ruling is briefly set out in paragraph 5 and footnote 4 but provides no detailed analysis. *Bywater* can only ever be authority for what had to be decided by the High Court, that is, whether Bywater's CMC was in Australia. The decision doesn't say anything by way of ratio decidendi, about whether CMC itself represents carrying on business. *Bywater's* comments in relation to *Malayan Shipping*, were thus obiter and whilst perhaps persuasive, would not be binding on a later court.

The ATO provides no further detailed analysis in its Decision Impact Statement on the High Court decision in *Bywater*:

> *"The approach the Commissioner took in TR 2004/15 in relation to the earlier High Court decision in Malayan Shipping can no longer be sustained. At [57] the majority of the court clearly agreed with Williams J's rejection of the contention that where a company has its central management and control in Australia it must, to be a resident of Australia, in addition also carry on its business operations in Australia. Therefore if a company carrying on business has its central management and control in Australia it will necessarily carry on business in Australia. That is so even when the only business carried on in Australia consists of that central management and control, and trading operations are conducted outside this country".*

1.C) The essence of the difference in ATO views between TR 2004/15 and the Draft Ruling

In our view, it is the interpretation of CoB that forms the essence of the difference in views between TR 2004/15 and the Draft Ruling:

TR 2004/15 at paragraph 10:

> "*For the purposes of the second statutory test, a company that has major operational activities relative to the whole of its business carries on business wherever those activities take place and not necessarily where its CMC is likely to be located*".

The Draft Ruling at paragraph 5:

> "*It is not necessary for any part of the actual trading or investment operations from which its profits are made to take place in Australia. This is because the central management and control of a business is factually part of carrying on that business. It follows that a company carrying on business does so both where its trading and investment activities take place, and where the central management and control of those activities occurs*."

The Draft Ruling is taking a wider view of carrying on business (per *Malayan Shipping*) and is doing away with the operating company versus passive / investment company dichotomy in TR 2004/15.

1.D) Professional Bodies' view of the Draft Ruling

It is submitted that the underlying reasoning associated with paragraph 5 of the Draft Ruling is not fully articulated. The Draft Ruling is essentially taking a wider view of CoB (per *Malayan Shipping*) and is doing away with the operating company versus passive/ investment company split in TR 2004/15.

Malayan Shipping and *Bywater* are with respect correctly decided. However, both cases involve extreme set of facts, far removed from the reality of multinational business in 2017 and both essentially involved passive / investment type-activities. It is considered that applying the ATO view in TR 2004/15 to the facts in those cases would lead to the conclusion that the relevant companies were residents of Australia.

As currently drafted, the Draft Ruling may significantly expand the scope of the second statutory test. This expansion of the scope of the corporate residency test may likely affect foreign incorporated

companies that carry out operational activities and may result in adverse tax consequences for Australian groups.

Analysis of Malayan Shipping

a) The second statutory test is a two limb test.

In our view, nothing in Williams J. decision in *Malayan Shipping* challenges the conclusion that the second residency test is a two-limb test, and that both parts need to be made out, as a matter of fact.

Whether one or both parts of the test is satisfied is a question of fact. It may be that the same or similar matters are relevant to both tests, depending upon the facts, but in our view, Williams J. did not conclude that there is an inference to be drawn about one test (e.g., CoB) from the conclusion of the other test (e.g., CMC). CMC was conceded in *Malayan Shipping.*

b) What was the contention advanced by the taxpayer in *Malayan Shipping*?

Malayan Shipping did not address the interpretation of CMC and accordingly, paragraph 57 in the *Bywater* High Court decision is not an occasion to revisit the principles of CMC, i.e. there is no inference to be drawn from the CoB test with respect to the 'central management and control test' or vice versa.

The contention advanced by the taxpayer in *Malayan Shipping* was solely in respect of the CoB test where the taxpayer tried to draw a distinction between 'control' of the operations of a business and the 'actual' operations. That contention was that "*the carrying-on of business could not refer to the control of the operations of business from which the profits arose but only to the actual operations themselves*".

It was that contention, or "construction of the definition" of CoB that Williams J. was "not prepared to accept":

> "*In the first place I am not prepared to accept Mr. Phillip's construction of the definition. In Mitchell v. Egyptian Hotels Ltd [2] Lord Parker of Waddington said: "Where the brain which controls the operations from which the profits and gains arise is in this country the trade or business is, at any rate partly, carried on in this country*."

The High Court decision in *Bywater* concluded that "Unsurprisingly, Williams J rejected that contention".

Williams J. rejected the contention when he says that the activities in Australia amounted to the "control of the operations" for the purpose of the CoB test:

> *"It appears to me, therefore, that, even if Mr. Phillips is right in contending that the sub-charters were of the essence of the trading operations and were made in Singapore, the company was nevertheless a resident within the meaning of the definition".*

According to Williams J., the CoB test can be satisfied by way of either or both of:

i) "Control of the operations", this aspect of the CoB test is referred to below as CoB / control of operations); and

ii) "Active business operations", this aspect of the CoB test is referred to below as CoB / active business operations.

1.E) Conclusion

Based on the above, it is the view of the Professional Bodies that the second statutory test is, and always has been, a two-limb test. This needs to be made clear in the final ruling as the ruling as currently drafted indicates it is a one-limb test.

The Professional Bodies also recommend that the Commissioner review the basis on which he has formed his view in paragraph 5 as in our view, there is no basis in the case law, including *Malayan Shipping,* to support the conclusions drawn in paragraph 5.

2. Defining each limb of the second statutory test (Submissions 2 and 3)

The Professional Bodies submit that each element of the second statutory test (i.e. CMC and CoB) needs to be clearly and separately discussed in the Draft Ruling.

2.A) Central Management and control

a) Principles of CMC

As stated above, nothing in *Malayan Shipping* affects the interpretation of the CMC concept.

It is well established in case law that CMC is the highest level of management of a company[2]. It is the "real place of business", where high level management decisions are taken, e.g. major decisions on policy directions or/and on significant financial matters, where strategic recommendations are made, where strategic decisions are taken.

This is to be contrasted with the lower level decision making, i.e. the day-to-day conduct and management of a company's activities and operations.

We agree with paragraph 6 of the Draft Ruling that the key element of the CMC "is the making of high-level decisions that set the company's general policies, and determine the direction of its operations and the type of transactions it will enter".

We consider each sentence in Paragraph 7 in turn below. Paragraph 7 of the Draft Ruling states that:

- "*The control and direction of a company is different from the day-to-day conduct and management of its activities and operations.* [Comment: correctly in our view implying that day-to-day conduct and management of activities / operations is not CMC]
- *The conduct of the company's day-to-day activities and operations is not an act of central management and control.* [Comment: correctly in our view – but query if this is drawing a distinction between "conduct and management" above versus "conduct" in this sentence]
- *Nor is managing those activities under the authority and supervision of higher level managers or controllers*" [Comment: this sentence could be interpreted to infer that if a person manages day-to-day activities not under the authority and supervision of higher level managers or controllers, this could be an act of central management and control]

It is submitted that further clarity is required with respect to paragraph 7, and that clarity is required on the scope of "management".

We agree with paragraph 14 of the Draft Ruling that the CMC will normally be exercised by the Board, and we also agree with paragraph 15 that there is no presumption that the Board will exercise CMC.

[2] The first case law decision to refer to the CMC concept was a UK case *De Beers Consolidated Mines Ltd* in 1907. Prior to De Beers, the UK case *Cesena Sulphur company Ltd v Surveyor of Taxes* in 1876 referred to the "central point of business", "the real place where the business is carried on"

b) CMC and role of the Board

We agree with the Draft Ruling that the focus of the CMC analysis is whether the role of the Board has been usurped or the Board has abrogated its decision making role – whether involving an outsider or an insider:

i) The High Court decision in *Koitaki*[3] is an example of where the CMC was found in Australia, by way of the role of the Board, and the activities in Papua were regarded as the conduct of operations and nothing more. The UK decisions in *Cesena*[4] and *De Beers*[5] are similar.

ii) *Bywater* and *Unit Construction*[6] are cases of where the role of the Board has been usurped by an outsider.

iii) *Malayan Shipping* is a case where the role of the Board has been usurped by an insider

iv) *Esquire Nominees*[7] and *Wood v Holden*[8] are cases where the role of the Board has not been usurped by an outsider, albeit that there may be a person of influence outside the Board.

c) Interaction between the place of CMC location & the place of actual operations

North Australian Pastoral[9] and *Waterloo Pastoral*[10] are cases that involve the intersection between the role of the Board and the role of local activity and local management (insiders). In neither of those cases was it submitted that the Board's role was usurped: rather it was recognised that in determining where CMC was located, the place of the actual operations may be a relevant factor.

Indeed, even where the Board (which has not been usurped) meets in another jurisdiction (such as in *Waterloo Pastoral*), such a company can be resident in the place where its business operations are conducted.

In *North Australian Pastoral*, Dixon J found that:

> *"There has not been a case so far in which, although the place where the substantial business of a company is carried on is the same as that of its incorporation and its formal life, the company has been held not to reside there"*

The ATO states in paragraph 5 of the Draft Ruling that if a company, incorporated offshore, carries on business, wherever, including solely offshore, has its central management and control located in Australia, then it is a resident of Australia. For example, where a company is incorporated in (say) Malaysia and is conducting substantial business in Malaysia, such a company could also be held to reside in Australia if the CMC of the company is in Australia i.e. a dual resident.

Importantly, the ATO acknowledges the principle of *North Australian Pastoral* in paragraph 28 of the Draft Ruling and states that the nature of a company's activities could be such that the CMC will be located where the actual business operations take place.

This is a critical point as it could mean that in many cases, the conclusion under the Draft Ruling will be the same as the conclusion that arises under TR 2004/15. That is, a company that carries

[3] *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* [1941] HCA 13
[4] *Cesena Sulphur company Ltd v Surveyor of Taxes* – UK case in 1876
[5] *De Beers Consolidated Mines Ltd* – House of Lords in 1907
[6] *Bullock v. Unit Construction Co. Ltd* – House of Lords in 1960
[7] *Esquire Nominees Ltd v Federal Commissioner of Taxation* [1973] HCA 67
[8] *Wood v Holden UK case in 2006*
[9] *North Australian Pastoral C0 Ltd v Federal Commissioner of Taxation* [1946] HCA 17
[10] *Waterloo Pastoral Co Ltd v Federal Commissioner of Taxation* [1946] HCA 30

on its actual business operations wholly outside Australia could be taken to be a non-resident of Australia, under both the Draft Ruling and TR 2004/15, albeit for different reasons:

- under TR 2004/15, the fact that a company carried on its actual business operations, wholly outside Australia, was of itself sufficient to conclude that such company was a non-resident of Australia under section 6(1)(b);

- under the Draft Ruling, the fact that a company carries on its actual business operations, wholly outside Australia, is not sufficient of itself to conclude that such company is a non-resident of Australia under section 6(1)(b). The company needs to determine where its CMC is located. In determining where the company's CMC is located, the place of its actual operations may be a relevant factor, i.e. its CMC may be located where the company's business activities take place, if so, such company is a non-resident of Australia

For clarification purposes, we recommend that paragraph 28 should be brought forward in the Draft Ruling as it refers to a key principle in determining a company's CMC location. The application of this principle is critical for a foreign incorporated company that carries out substantial operational activities offshore in determining its residence status under section 6(1)(b). In addition, examples and discussion regarding the location of CMC should be included in the ruling, as well as practical guidance on the use of electronic / telephonic participation in directors meetings (as was done in Example 1(d) of TR 2004/15).

2.B) Carrying on business

a) CoB /Control of the operations test

The critical aspect of *Malayan Shipping* is the concept of "control of the operations" with respect to the CoB test. However, there is very little analysis of that concept in *Malayan Shipping* and the Draft Ruling does not address the definition or the scope of the "control of operations".

The principle that the CoB test can be satisfied by way of "control of the operations" is to be first found in the UK cases such as *Mitchell v Egyptian Hotels*[11] (referred to in *Malayan Shipping*). Those UK cases[12] looked at the conduct of the Board to determine whether the taxpayer carried on trade or business in the UK via the activities relating to the control of the operations.

The question in *Mitchell* was not a question of residency or CMC of the company (whether in London or Egypt). The case dealt with where was the company carrying on trade or business? It was held by the House of Lords that the trade or business of the company was carried on wholly outside the UK (notwithstanding that the CMC and residency was taken to be in the UK).

We submit that the scope of the CoB limb in the second statutory test needs to be clarified and in particular, what is meant by "control of the operations".

b) No inference is to be drawn from the CMC test with respect to the CoB test

Williams J. states that:

> *"If the business of the company carried on in Australia consists of or includes its central management and control, then the company is carrying on business in Australia and its central management and control is in Australia" (emphasis added).*

This is a hypothetical – it is not a statement of principle that if the CMC is in Australia, then the company also will CoB in Australia. That is saying that, if as a matter of fact, "the business of the

[11] *Mitchell v. Egyptian Hotels Ltd. [1915] UKHL 2*: the question dealt in Mitchell case was not the question as to where was the residence of the company (whether in London or Egypt) but where was the company carrying on trade or business?
[12] Refers to other UK cases *Colquhoun (Surveyor of Taxes) v. Brooks [1889] House of Lords reported L.R. 14 App. Cas.493, and San Paulo (Brazilian) Railway Company Ltd v. Carter (Surveyor of Taxes) [1895] House of Lords,*

company carried on in Australia consists of or includes its central management and control", then it will be the case that the "company is carrying on business in Australia and its central management and control is in Australia".

However, it remains a question of fact to conclude whether it is the case that the "the business of the company carried on in Australia consists of or includes its central management and control".

Williams J. then considers another hypothetical:

> *"If, on the other hand, a company incorporated elsewhere is merely trading in Australia and its central management and control is abroad, it does not become a resident of Australia unless its voting power is controlled by shareholders who are residents of Australia"*

In our view, Williams J. does not conclude that the facts that amount to the "control of the operations" in the context of the CoB test necessarily also establish the location of the CMC, i.e. there is no inference to be drawn from the CoB test with respect to the CMC test or vice versa.

Indeed, as noted by the High Court in *Bywater*, "it was conceded that central management and control … was exercised in Melbourne" and so Williams J. did not need to consider the CMC aspect of the second residency test.

c) Purpose of the CoB test - limits the scope of the second statutory test

Australia intentionally adopted a definition of residency in 1930 that differed to that adopted in the United Kingdom (the UK). The UK test was a Common Law test based on CMC. Australia expressly adopted three alternative tests of residency, and in respect of the second test, that test was both CMC in Australia and carry on business in Australia.

We respectfully disagree with the following comments of Williams J. that:

> *"The purpose of requiring that, in addition to carrying on business in Australia, the central management and control of the business or the controlling shareholders must be situate or resident in Australia is, in my opinion, to make it clear that the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia".*

If Australia had instead simply adopted the UK model (CMC in Australia) it would have been equally clear that (to use the words of Williams J.) "the mere trading in Australia by a company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia".

In our view, the inference to be drawn from the express statutory language adopted by Australia in the second statutory test, is that in respect of a company not incorporated in Australia, the COB test is a limitation or a narrowing of the scope of residency, as compared to a test which simply asked whether the CMC was in Australia. Australia expressly adopted a different formulation of the test of residency as compared to the UK.

Application of the Draft Ruling to Australian Groups (Submission 4)

We are particularly concerned about the application of the preliminary views in the Draft Ruling on Australian outbound groups, where there is an Australian parent and a foreign incorporated subsidiary.

3.A) General comments

In many ways, the Australian tax system in respect of corporates operates on the basis that Australian-based profits and activities should be taxed in Australia and that foreign-based profits and activities should not be taxed in Australia, e.g. Subdivisions 768-A 768-G of the *Income Tax*

Assessment Act 1997, and section 23AH of the *Income Tax Assessment Act 1936*. These principles are supported by effective integrity measures in Part IVA, Division 815 and the CFC provisions, in cases where an Australian group has a foreign subsidiary.

An overly complicated application of the tests of residency or an expanded scope of residency having regard to the roles and functions of an Australian parent at the centre of a global organisation could lead to a hollowing out of Australian based skills, functions and operations.

3.B) TR 2017/D2 impact on Australian outbounds

Malayan Shipping and *Bywater* both involve extreme set of facts, far removed from the reality of multinational business in 2017 and both essentially involved passive / investment type-activities.

The lack of analysis of the distinction between substantial foreign operating companies, and the companies considered in the *Bywater* case, mean that a literal reading of the conclusions in the draft ruling could result in any and all Australian owned and supervised foreign companies to be Australian residents regardless of their business purpose (i.e. investment/holding versus operational).

The 1975 Commonwealth Taxation Review Committee (the Asprey Committee) identified these issues and rejected this type of interpretation because:

> *"This wide meaning would, however, increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable: many wholly-owned subsidiaries of Australian resident companies, though incorporated in foreign countries and resident there, could become Australian resident companies"*

And the 2002 Treasury Consultation Paper on the Review of International Taxation Arrangements commented on the uncertainty if the second statutory test was taken too far:

> "*However, the case law[13] is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this*"

The above two authorities support our view that the interpretation proposed in the Draft Ruling would do significant damage to Australian taxpayers and the Australian tax system.

As currently drafted, the Draft Ruling may significantly expand the scope of the corporate residency test. This expansion of the scope of the corporate residency test would likely affect foreign incorporated companies that carry out operational activities offshore.

The Commissioner's preliminary interpretation of the second statutory test may result in adverse tax consequences for foreign incorporated companies that are taken to be Australian residents under the second statutory test.
Consider an Australian resident parent company (AusCo) that has a manufacturing entity in Malaysia (Malaysia Sub incorporated in Malaysia) which is taken to be an Australian resident under the preliminary view, and would not have been taken to be an Australian resident under TR 2004/15. The activities of Malaysia Sub would likely constitute a permanent establishment in Malaysia and the income derived from the business operations carried on in Malaysia should be non-assessable non-exempt income under section 23AH. So *prima facie*, the Commissioner's view in the Draft Ruling should not trigger any adverse tax implications.

However, this new interpretation will have many consequential impacts. For example, debt deductions in Australia may no longer be available under section 25-90 of the *Income Tax Assessment Act 1997*. Another example is where the Australian parent company disposes of the shares in Malaysia Sub as Division 768-G would not apply to reduce a capital gain or loss.

[13] This is referring to Malayan Shipping case

A range of other adverse tax implications for Australian outbound groups could arise including (but not limited to) that dual resident entities may lose treaty benefits (in a post BEPS world), and that a prescribed dual resident cannot be a member of a consolidated group.

We submit the Commissioner needs to formalise his view with respect to:

a) the application of the CoB /control of operations test under the second statutory test in an Australia parent / foreign subsidiary case to prevent expansion of the scope of Australian residency for Australian outbound groups, and

b) the application of the *North Australian Pastoral* principle in an Australian parent / foreign subsidiary case, where the foreign incorporated subsidiary carries on substantial operational activities offshore.

We submit that the Draft Ruling should be enhanced by a series of examples, as was the case in TR2004/15. Working through examples would allow proper consideration of key elements missing from the Draft Ruling including notably the distinction between *Bywater* type investment companies and real operating foreign subsidiaries with real foreign executives and operations.

TR2004/15 and its long-standing ATO view have informed major commercial investments and decisions by many major Australian companies. We highlight in particular, two strategic examples 2 and 7 in TR2004/15 which would need to be expressly considered in this Draft Ruling.

We would be pleased to participate in a workshop to develop the examples.

3. Carrying on a business for the purpose of the third statutory test (Submission 5)

The Professional Bodies submit that any guidance provided in the Draft Ruling on the CoB limb will also apply to the third statutory test for corporate residency.

4.A) General comments

The term 'carrying on a business' is also relevant for the purpose of the third statutory test, being the carrying on of business in Australia and voting power controlled by shareholders who are residents of Australia. As a result, the views in the Draft Ruling on CoB also raise uncertainty in respect of the third statutory test. Therefore, any guidance provided in the Draft Ruling on CoB will also apply to the third statutory test.

The Draft Ruling does not address the third statutory test. Given that *Malayan Shipping* addressed the CoB limb and that the CoB limb is an element of both the second statutory test and the third statutory test, we submit that the implications of the ATO view on the second statutory test must be finalised in conjunction with an assessment of those views on the third statutory test.

4.B) Critical to clarify the scope of CoB / control of operations

The ATO view in the Draft Ruling is that if CMC is in Australia, a company that carries on business (wherever) will also meet the CoB test.

Consider this scenario:

- A foreign incorporated company (Forco) has its CMC offshore and does not conduct actual operations (e.g., trading activities) in Australia. The CMC aspect of the second statutory test will not be met and the company will not be a resident of Australia under the second statutory test.

- Under the second statutory test, once the CMC is held to be offshore, no further analysis is required about the CoB test.

In respect of the above scenario, where Forco is wholly owned by an Australian parent, it is likely that the voting power of Forco is controlled by shareholders who are residents of Australia.

The critical question is whether Forco meets the CoB test in Australia. As noted in the example, Forco does not conduct actual operations (e.g., trading activities) in Australia. However, the question remains, does Forco carry on business in Australia in the sense of having the "control of its operations" in Australia [so something less than central management and control?]

It is in this context that it becomes critical to determine the scope of the CoB / control of the operations test.

A critical matter in this regard is whether the CoB test can be met even if only a small part of the business of Forco is potentially in Australia, including via the COB / control of the operations.

We comment below on a possible approach to address this concern:

a) The preliminary view of the ATO is that (in respect of a foreign incorporated company carrying on a business) if CMC is in Australia, then the company "will" carry on business in Australia (this is referring to the CoB / control of operations test). Whilst we do not accept that there is an inference that CMC necessarily establishes CoB / control of operations, we acknowledge that on a factual review, this may be the appropriate conclusion.

b) Applying that same view to Forco in the scenario above, if the CMC of Forco is offshore (e.g. with the Board of Forco), would the ATO also conclude that the company "will" only carry on business offshore (reiterating that in this scenario, there is no trading activity of Forco in Australia).

    i) This requires an analysis of the scope of CoB / control of operations. It is noted that the old UK cases (including *Mitchell v. Egyptian Hotels* referred to in *Malayan Shipping*) tested the question of whether the companies were carrying on a trade and business in the UK by reference to the activities of the Board / Directors in the UK, and so provides support that the principal focus of CoB / control of operations test is on the same high level decision making as the CMC test is focused on.

    ii) If on the other hand the CoB / control of operations looked at day-to-day management type decisions, this could significantly expand the scope of the third statutory test.

        - Consider the Forco scenario above, and assume that the CMC of Forco is offshore with the Board of Forco.
        - The activities of Forco are part of a worldwide business line conducted in Australia and in various foreign countries.
        - The global management personnel of that worldwide business line are located in various countries but in large measure are based in Australia (e.g., employees of the parent company).

We are concerned that in the absence of clarification on the scope of CoB / control of operations, acts of the day-to-day management personnel in Australia could be taken (even if only to a small extent) to mean that the CoB / control of operations of Forco is (in part) in Australia.

Consistent with the CMC focus on high level decision making and consistent with the focus on Board / Directors in *Mitchell v. Egyptian Hotels*, it is considered that the CoB / control of operations test should be analysed in the context that:

a) CoB / control of operations will typically be made out by similar facts that determine the location of CMC. That is, both tests are looking at the location of high level strategic decisions, and not the location of day to day management decisions.

b) Management acts of personnel in Australia (e.g., employees of the parent company with global management responsibility) will typically be seen to be the carrying on of the business of the Australian parent company, and not the carrying on of the business of Forco.

Whilst CoB / active business operations can clearly be conducted in a number of countries, it is submitted that CoB / control of the operations is typically located in one country in the same way that CMC is typically located in one country. In the context of CMC, it is accepted that an Australian parent can provide CMC type input (even influence) which can be "localised" by Forco via an effective Board process, so too should it be that an effective Board process of Forco will also be taken to localise acts of Ausco (if any) which may rise to the level of control of the operations of Forco – so that the COB / control of the operations is located in Forco's jurisdiction.

The concerns with the scenario above are highlighted by the fact that if the CMC is offshore, but the company could be an Australian resident under the third statutory test, it is also likely that the company could have its "place of effective management" offshore, and so would be treated under any relevant double tax treaty as a resident of the other country. This could have a range of particularly adverse outcomes including in respect of the operation of double tax treaties and the tax consolidation provisions (e.g., dealing with prescribed dual residents).

We submit that:

a) The implications of the ATO's preliminary views on the second statutory test must be clarified in conjunction with a ruling on the third statutory test

b) The Commissioner needs to formalise his view with respect to the application of the CoB /control of operations test under the third statutory test in an Australia parent / foreign subsidiary case to prevent expansion of the scope of Australian residency for Australian outbound groups.

c) The Draft Ruling should involve development of a series of examples to illustrate the issues, in the same manner as TR2004/15 to highlight the distinction between operating and investment companies. , This would increase certainty for Australian businesses investing and operating offshore**.**

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APPENDIX

Corporate residency definition & associated reviews – Background

1. Corporate residency definition

There are three alternative tests in the corporate residency definition under section 6(1)(b):

a) incorporation in Australia (incorporation test);

b) carrying on business in Australia and central management and control in Australia (the second statutory test); and

c) carrying on business in Australia and voting power controlled by shareholders who are residents of Australia (the third statutory test).

The corporate residency definition was first introduced in 1930[14]. With respect to the two non-incorporation tests, the necessity to include such a definition was expressed at the time as follows:

> *"Such a definition is necessary because of the number of companies incorporated outside Australia whose sole or principal business is located in Australia"*[15]

In 1936, the corporate residency definition was incorporated in the *Income Tax Assessment Act 1936* under section 6(1)(b). The second statutory test has been subject to much uncertainty since its introduction. However, the legislative definition has remained unchanged to date.

2. Taxation Review Committee in 1975

In 1975, the Commonwealth Taxation Review Committee (the Asprey Committee) concluded that in its view, "it should be enough to give a company residence in Australia that its central management and control is here". However, it is submitted that in context, this is a view as to how the residency test should be defined rather than a commentary on the existing residency test.

The Committee also commented at paragraph 17.15 on the scope of the CMC and the risk entailed if its scope was wide enough to include the "exercise of control and direction of the company's affairs otherwise than in the formal proceedings of the board-room":

> *"The meaning of central management and control calls for clarification. It would bring some tax-haven companies within the jurisdiction of Australian tax if these words were held to be wide enough to include the exercise of control and direction of the company's affairs otherwise than in the formal proceedings of the board-room. It might be thought to be enough to give a residence in Australia that the board of directors habitually responds to instructions formulated in Australia, even though the board meets elsewhere. This wide meaning would, however, increase the likelihood of a company being resident both in Australia and in a foreign country to a degree that might be regarded as unacceptable: <u>many wholly-owned subsidiaries of Australian resident companies, though incorporated in foreign countries and resident there, could become Australian resident companies</u>"* (emphasis added).

[14] By amending the *Income Tax Assessment Act 1922*

[15] Note on Clause 2 in Explanatory Notes on Amendments contained in a Bill to amend the *Income Tax Assessment Act 1922-1929*

3. Treasury Consultation Paper in 2002

In 2002, the Treasury released a Consultation Paper on the *Review of International Taxation Arrangements* (the RITA Consultation Paper) commented on the uncertainty of the second statutory test:

> "*Largely, difficulties with the current tests of company residency arise because of uncertainty about applying the test that looks at whether a company's central management and control is in Australia and whether it carries on a business here. The Australian Taxation Office applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. However, the case law[16] is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this*"

The RITA Consultation Paper proposed the following option for consultation on page 54:

> *"Option 3.12 for consultation: to consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business".*

4. Board of Taxation recommendations in 2003

In February 2003, the Board of Taxation (BOT) released its recommendations[17] with respect to the RITA Consultation Paper proposals, and noted:

> "*To assist in establishing Australia as a centre for internationally-focused companies, it is necessary to have clear, practical and internationally-acceptable rules for company residence. It is also necessary to resolve issues that arise when a company is a dual resident, that is, treated as a resident in two or more countries under the respective countries' tax laws"*18*.*
>
> *"(…). The main objective of the company residence test should be to produce certainty and ease of operation"* [19]*.*

The BOT highlighted that the CMC test created uncertainty (referring to the High Court case *Malayan Shipping*) which was contrary to the policy objective of the corporate residency:

> "*Another complication is introduced by an early High Court case which held that a company which is managed in Australia is likely to carry on business here. This has the potential to make foreign subsidiaries of Australian companies resident in Australia, even though the subsidiaries are incorporated and operate outside Australia. To prevent this possibility, Australian companies may deliberately seek to appoint a majority of directors resident in the country of incorporation of the subsidiary and hold board meetings there. In practice, however, these directors are likely to closely follow the views of the Australian parent company, thus leaving the place of management unclear*"

The BOT considered options to clarify the CMC test so that exercising CMC alone did not constitute the carrying on of a business. The Board recommended "*that in the interests of certainty for taxpayers and ease of administration, the test for residency be based solely on incorporation*"[20].

In May 2003, the Government decided to defer consideration of changes to the domestic tests of company residence recommended by the BOT pending the release of a draft taxation ruling clarifying the operation of those tests[21]. The ATO released in 2004 taxation ruling TR 2004/15.

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[16] This is referring to *Malayan Shipping* case
[17] International Taxation, A Report to the Treasurer, Volume 1, The Board of Taxation's Recommendations, 28 February 2003
[18] At paragraph 3.122 of BOT recommendations
[19] At paragraph 3.129 of BOT recommendations
[20] Recommendation 3.12: "The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia"
[21] Treasurer 'Review of International Taxation Arrangements' – Press Release No 32, 13 May 2003: "The Government deferred consideration of recommendation 3.12 until the release of a tax ruling. The relevant ruling was issued as TR2004/15 on 20 October 2004 by the Australian Taxation Office, and is intended to clarify the operation of the central management and control test for corporate residency"